CAPITAL PROJECTS AND BOND OVERSIGHT COMMITTEE

Minutes

March 15, 2011

Call to Order and Roll Call

The Capital Projects and Bond Oversight Committee met on Tuesday, March 15, 2011, at 12:00 p.m., in Room 169 of the Capitol Annex. Senator Bob Leeper, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Bob Leeper, Co-Chair; Representative Jim Glenn, Co-Chair; Senators Tom Buford, Jared Carpenter, and Julian M. Carroll; Representatives Steven Rudy and Jim Wayne.

Guests: Tom Howard and Brett Antle, Office of Financial Management; John Hicks, Governor's Office for Policy Management; Bob Wiseman, University of Kentucky; Charles Bush, Division of Real Property; Sandy Williams, Kentucky Infrastructure Authority; Joe Pavoni, GRW Engineers; and Denny Gallagher, Nicholas County Sanitation District #2.

LRC Staff: Kristi Culpepper and Samantha Gange.

Approval of Minutes for January 18, 2011

Representative Rudy made a motion to approve the minutes of the January 18, 2011, meeting. The motion was seconded by Senator Buford and approved by voice vote.

Resolution Honoring Representative Susan Westrom

Senator Leeper read a resolution honoring Representative Westrom and her service to the committee.

Senator Carroll made a motion for the resolution to be adopted by the committee. The motion was seconded by Representative Glenn and adopted by voice vote.

Correspondence Items

Senator Leeper asked Kristi Culpepper, Staff Administrator, to discuss correspondence items. Ms. Culpepper said members' folders contained five items of correspondence. The first two items of correspondence were to Secretary Miller, Finance and Administration Cabinet, regarding no action being taken on projects because of cancellation of the February 2011 committee meeting; and correspondence from Secretary Miller notifying the committee that the projects from the February 2011 committee meeting would proceed.

Ms. Culpepper said the third item of correspondence was a letter from the Office of Financial Management (OFM) explaining that the bond counsel for the University of Kentucky (UK) and the University of Louisville's qualified energy conservation bonds has corrected the federal subsidy calculations on the bond issues. The results benefit both universities.

Discussion of Kentucky Asset/Liability Commission Disclosure Filing

The fourth item of correspondence was a letter from OFM notifying the committee that the Kentucky Asset/Liability Commission (ALCo) had filed a voluntary disclosure, which has been posted on the Municipal Securities Rulemaking Board's website. The voluntary disclosure explains that the state's counterparty has changed on the four interest rate swap agreements hedging ALCo's General Fund Floating Rate Project Notes, 2007 Series A and Series B. Deutsche Bank replaced Citi as the swap counterparty on February 14, 2011.

Ms. Culpepper explained that the 2007 deal provided permanent financing for the state's grant to the Louisville Arena Authority and the Petroleum Storage Tank Environmental Assistance Fund and refunded some outstanding debt. This was the first time the state has used a floating rate note structure to issue bonds. To hedge the state's variable interest rate exposure, ALCo entered into four swap contracts where ALCo received payments corresponding to the variable rate owed on the floating rate notes and paid Citi a fixed rate. The swap effectively converted the variable rate debt to a fixed rate.

In December, the insurer on the bonds and swaps was downgraded below the rating threshold specified in the swap contract, which was an event that gave Citi the right to terminate the swaps. If Citi would have terminated the swaps, the state would have had to make a substantial termination payment because the swaps had a negative market value at the time. However, Citi agreed assign the swaps to Deutsche Bank instead. There were no changes to the financial terms of the swap contracts, and the assignment produced no cost for the state beyond bond counsel fees for the required enforceability opinion. The most significant modifications made to the original swap contracts are that the new swaps are not insured and the state's rating would have to fall below the A3 / A- level to trigger the automatic termination of the swaps, which is the same level as that for the counterparty and reflects the fact that municipal borrowers are now being rated on the same scale.

Committee Member Questions

In response to a question from Senator Buford, Tom Howard, Executive Director, OFM, said there was no negative budgetary impact. He said the Commonwealth has entered into the four interest rate swaps on a cost-of-funds basis, which means the counterparty pays the exact cost of funds on the floating rate leg and the Commonwealth continues to pay the agreed upon fixed-rate on the bonds.

Senator Buford asked what the current market valuation was on the outstanding swap contracts. Mr. Howard said the cumulative market value of the four swaps given the current rate environment is about negative $20 million should the swaps be terminated. He said he does not anticipate the swaps being terminated. He said Deutsche Bank cannot terminate the agreement unless the Commonwealth is downgraded below a threshold of A3 / A- and the Commonwealth's is currently rated Aa2 with a negative outlook by Moody's Investor Service, AA- with a negative outlook by Fitch Ratings, and A+ by Standard and Poor's. He said the Commonwealth's ratings are considerably above the termination trigger.

In response to another question from Senator Buford, Mr. Howard said the Turnpike Authority of Kentucky (TAK) ratings are viewed different than the state's General Fund ratings. He said on the General Fund side, the Commonwealth faces significant pension liability issues and the rating agencies cite this as a major concern when rating the state. He said the structural imbalances of state pensions are concerns with the rating community.

In response to a question from Senator Carroll, Mr. Howard said an interest rate swap is an exchange of interest payments. Deutsche Bank is not assuming principal repayment risk. He said the bank has agreed to pay the Commonwealth its cost of funds on its Floating Rate Notes, and in exchange the Commonwealth has agreed to pay a fixed interest rate based on market conditions at the time the swap was executed. The bank is net-neutral on the transaction. The bondholder has the exposure in that the Commonwealth will repay the principal and interest.

Senator Carroll asked if there is authorized but unissued debt. Mr. Howard said the Commonwealth has a fair amount of unissued debt from previous budget cycles. He said pre-2010 budget there is $604 million of unissued debt, of which $233 million is General Fund, $200 million is Road Fund, $40 million is Agency Fund, and $131 million is supported by federal funds for the Louisville Bridges project. From the 2010-2012 budget, there is approximately $1.9 billion of unissued debt, which represents $132 million of General Fund, $522 million Road Fund, $466 million Agency Fund, and $435 million of GARVEEs for the Western Kentucky Bridges project.

Senator Carroll asked how the restructuring of debt will affect the state's current bond ratings. Mr. Howard said the restructurings are relatively modest to small in size in comparison to the budget. He said debt restructuring is not the primary driving force of the state's rating. However, continued debt restructuring is not a preferred strategy. He said out of the maturing debt, within five years the state will have 27 percent of debt maturing and within 10 years 60 percent of debt maturing. The duration is relatively short on a significant amount of obligation, which is within the rating target in terms of liability.

Senator Buford asked if there was any concern with the swap agreements with regard to the bond insurer FGIC. Mr. Howard responded no. He said there were two issues with respect to the bond insurance. One, the Commonwealth issued notes with FGIC insurance, which was assumed by MBIA (with a subsidiary called National). This piece involves the bondholders assuming the risk that the insurer will pay them if the Commonwealth does not. The state has no exposure; it is strictly an investor exposure. Two, they insured the swap payments from the Commonwealth to Citibank. The fact that the swap policy was in place was not a credit concern of the state's until it hit the trigger. Once the trigger was struck, then the state arranged the assignment of the swap contracts with Deutsche Bank. Citibank agreed to the assignment. Deutsche Bank did not want the insurance policy and National agreed to drop it. The Commonwealth is no longer relying on a third party to guarantee the payments to Deutsche Bank.

Correspondence Continued

Ms. Culpepper said the fifth item of correspondence was a notice from the Finance and Administration Cabinet regarding advertisement of leased space that would provide office and warehouse space for the Labor Cabinet in Franklin County.

Information Items

Ms. Culpepper said members' folders contained several information items. The first information item was a report from the Auditor of Public Accounts (APA) regarding certain procedures, controls, and finance activities of Mountain Water District. The auditor's report included eight findings and 40- recommendations, and was also referred to the Kentucky Attorney General's Office and the Legislative Ethics Commission for their consideration. The committee has reviewed various line-item water and sewer infrastructure grants and a Fund A loan for the district in the past.

In response to a question from Senator Buford, Sandy Williams, Financial Analyst, Kentucky Infrastructure Authority (KIA), said that they were not aware of the audit at the time the Fund A loan was made. She said KIA was contacted by the APA after the Fund A loan was approved by the committee and the KIA Board. KIA did not have any problems receiving financial information from the Mountain Water District.

The second information item was a special report released by Moody's Investors Service, one of three rating agencies that grade Kentucky's debt, which combines states' bonded indebtedness and unfunded pension liabilities, then ranks states according to the various credit rating indicators the agency uses.

The third information item was a rating report from Fitch Ratings for the ALCo Kentucky Teachers Retirement System (KTRS) Notes issued in February 2011. Fitch has assigned Kentucky's appropriation-supported debt rating a negative outlook.

The fourth information item was another report from Fitch Ratings on states' pension liabilities explaining changes that the rating agency has made to its analysis. Fitch is implementing a standardized seven percent investment return assumption. Fitch generally considers a funded ration of 70 percent or above adequate and less than 60 percent weak. At a seven percent discount rate, Fitch considers the Kentucky Employees Retirement System 41.6 percent funded, and KTRS 60.3 percent funded.

The fifth information item was a quarterly follow-up report from the School Facilities Construction Commission (SFCC) regarding bonds sold with SFCC debt service participation.

The sixth information item was a report detailing the available balances within the various loan funds administered by KIA for the 2011 funding cycle.

The seventh information item was an Energy Savings Performance Contract from the Finance and Administration Cabinet to make energy efficiency improvements in various buildings in Frankfort. The total project cost is $2.6 million, which will be financed over 14 years through the Kentucky Green Bank Program's revolving loan fund. The interest rate on the loan is 2.25 percent and annual lease payments will be $225,372.

The eighth information item was certifications from a representative of the APA, which are required by statute, explaining that the selection processes for underwriters, bond counsels, and other professional services to be provided to state-level issuers in compliance with the Kentucky Model Procurement Code.

The ninth information item was a preliminary new bond issue report for the TAK. The authority is exempt from the committee's review by statute, but OFM has agreed to provide this information as a courtesy to the committee. The new bond issue, which will be in an amount not to exceed $200 million, will do three things. First, it will provide permanent financing for $56 million of BRAC projects as authorized in HB 3 of the 2010 Extraordinary Session. Second, it will refund $55.3 million of outstanding 2001 Turnpike bonds for a present value savings. Third, it will restructure approximately $33 million of fiscal year 2011 Road Fund debt service. The restructuring will produce a cash flow savings of $32 million by pushing debt due now out into future years, but it will come at a cost of $10.8 million.

Discussion of the Turnpike of Kentucky Debt Restructuring

Senator Leeper asked why the cost to restructure is higher than anticipated. Mr. Howard said the enacted 2010-2012 budget assumed debt restructurings for TAK of $52 million in fiscal year 2011 and $53 million in fiscal year 2012. He said the initial calculations were based on gross debt service and not net of a BAB subsidy, which increased the number by approximately $9 million.

In response to another question from Senator Leeper, John Hicks, Deputy Director, Governor's Office of Policy and Management, said in the last interim quarterly revenue report published by the Office of the State Budget Director projected Road Fund receipts for fiscal year 2011 will exceed estimated amounts of $69 million. Of that $69 million, $29.5 million is statutorily committed to local governments and approximately $39 million will accrue to the Road Fund surplus. He said the state will have to restructure $33 million in debt to be within the debt service appropriation in the enacted budget. The additional revenues are not yet available for appropriation. Mr. Howard noted that the debt structuring for the Road Fund differs from debt restructuring of the General Fund, whereas the General Fund pays operating expenses and the Road Fund pays for cash-funded road projects.

Senator Leeper asked if an increased appropriation could have been requested during the 2011 Regular Session. Mr. Hicks said the surplus estimate is internal and unofficial and might not be sufficient enough for the General Assembly to take formal action.

Representative Wayne commented that he was concerned that the Commonwealth is paying $10.8 million to restructure $33 million in debt.

In response to a question from Representative Wayne, Mr. Howard said in the event that the Commonwealth where downgraded to the single A level it would cost about 20 or 30 basis points, which equates to approximately $3 million per $1 billion. Mr. Hicks said if that were to happen it would only apply to unissued debt and have no affect on the existing debt or pension liabilities.

Senator Carpenter asked what the terms of the restructuring where. Mr. Howard said the terms of the TAK debt restructuring include taking both the principal and the interest and moving it out into future years. OFM is amortizing the full principal out 9-10 years.

Senator Buford asked if the Governor has the authority to restructure and create new debt without General Assembly approval. Mr. Hicks said the restructuring of debt does not create new debt. He said the constitutional provisions in Chapter 56 of the statute say that only the General Assembly can authorize debt.

Information Items Continued

Ms. Culpepper said the last three information items included proposed legislation related to the jurisdiction of the Capital Projects and Bond Oversight Committee from the 2011 Regular Session and the staff and bond market updates.

University of Kentucky Projects

Senator Leeper asked Bob Wiseman, Vice President for Facilities Management, University of Kentucky (UK) to report on five projects. Mr. Wiseman said the first item was an unbudgeted capital project for the Renovate Schmidt Vocal Arts Center project. The project was authorized in 2010 Extraordinary Session HB 1 (2010-2012 budget) for $1,500,000 in restricted funds. UK expects to be able to pay for the project with $1,350,000 in private funds achieved through fundraising efforts and $150,000 of university restricted funds. The UK Board of Trustees approved the project at its February 2011 meeting.

The second item was for an unbudgeted capital project for the purchase of Medical Equipment and Systems (Ambulatory Electronic Medical Records). The project is required for UK to comply with federal requirements enacted in the 2009 Health Information Technology for Economic and Clinical Health Act and the 2010 Patient Protection and Affordable Care Act, which requires health care providers to implement electronic medical records. The project is estimated to cost $51,767,000. UK expects to receive $26 million in federal funds and the remaining funding for the project will come from a $15 million tax-exempt lease-purchase agreement and $11 million from UK Health Care operations. This project is being submitted to the committee ahead of the Council on Postsecondary Education (CPE) because CPE does not meet until April and delaying the project could entail UK being penalized under the new federal legislation. The committee's approval would be contingent on CPE approval.

Mr. Wiseman said the third item was a consolidation of budget authorizations for the Upgrade Student Center Infrastructure and the Repair, Upgrade, Improve Building Mechanical Systems. The $23,000,000 project will be funded with $17,805,000 in agency bonds and $5,195,000 of accumulated funds in the Student Center Renewal and Replacement fund. This project will repair, upgrade, and improve existing building infrastructure systems at the UK Student Center. The UK Board of Trustees approved the consolidation at its February 2011 meeting. Debt service on the agency bonds will be supported by the Student Center Mandatory fee.

The fourth item was for a scope increase for the Renovate/Expand the Center for Applied Energy Research. UK is requesting a $403,003 scope increase to be paid from federal funds from the US Department of Energy. The funds will be used to conduct a Front End Engineering and Design Study for a refinery and to construct a 3,000 gross square foot shell facility to house the refinery. The committee approved a $1,712,581 scope increase for the budgeted project in January 2009. Pursuant to UK Administration Regulations, President Lee Todd approved the scope increase on March 3, 2011.

Representative Rudy made a motion to approve the four projects for UK. The motion was seconded by Senator Carroll and passed unanimously by roll call vote.

Mr. Wiseman said the fifth item was a report on the status of the Construct Patient Care Facility project. Because of the substantial scope of this project, which includes multiple authorizations across budget cycles, UK has made a practice of providing the committee with periodic updates on the project's status. He said in October 2008 the committee approved the university's request to consolidate $250 million of authorizations, bringing the total project scope to $700 million. At its February 2011 meeting, the UK Board of Trustees increased its scope from $570 million to $575.6 million, and approved the initiation of the $5.6 million Data Center and Related Support Space phase of the project. No committee action was required.

Project Scope Increase from the Finance and Administration Cabinet

Senator Leeper asked Mr. Hicks to present one item. Mr. Hicks said the Finance and Administration Cabinet is requesting approval of a scope increase for the Kentucky Department of Veterans' Affairs (KDVA), Western Kentucky Veterans' Center Alzheimer's/General Care Unit project. The scope increase is $900,000 with a revised project scope of $9,900,000. The additional funds will be provided from the US Department of Veterans' Affairs (USDVA) $438,750 and $461,250 from unbudgeted restricted funds. The additional $461,250 required from the state can be paid for with KDVA receipts, which are greater than expected this fiscal year due to a higher per-resident daily rate from USDVA for rates at the state's veterans' nursing homes. The scope increase was necessitated due to construction bids being higher than estimated.

Representative Rudy made a motion to approve the scope increase. The motion was seconded by Representative Glenn and passed unanimously by roll call vote.

Report of New Lease from the Finance and Administration Cabinet

Senator Leeper asked Charles Bush, Director, Division of Real Property, Finance and Administration Cabinet, to report a new lease. Mr. Bush said the new lease was for the Department of Kentucky State Police for new space for the Western Regional Forensic Laboratory currently leased under PR-3281. The department indicated a need for 9,211 square feet of office/laboratory space with a sprinkler system. The annual rental cost is $110,880 effective through June 30, 2018.

Senator Buford made a motion to approve the new lease. The motion was seconded by Senator Carroll and passed unanimously by roll call vote.

KIA Fund A Loans

Senator Leeper asked Ms. Williams to present several loan requests. Ms. Williams said the first loan request was a $1,400,000 Fund A loan for the City of Campton in

Wolfe County for the West KY 15, Quillins Chapel, and North Campton Sewer Line Extension project. The loan term is 20 years with an interest rate of one percent. The project also qualifies for 30 percent of additional subsidization in principal forgiveness.

The second request was a $3,400,000 Fund A loan for the Louisville and Jefferson County Metropolitan Sewer District for Phase I green infrastructure improvements in the Northeast and Northwest Focus Areas. The loan term is 20 years with an interest rate of one percent. The project also qualifies for Green Project funding for $3,400,000 under the category Green Infrastructure.

Senator Buford asked how the project qualified for a one percent hardship rate when Jefferson county’s median household income is higher than that of the Commonwealth. Ms. Williams said the district submitted census tract information for the specific areas affected by the project. She said the median household income for the project area is less than 80 percent of the Commonwealth, which qualifies the project for the one percent hardship rate.

In response to a question from Senator Carroll, Ms. Williams said KIA obtains the census tract information from the Kentucky State Data Center and the US Census Bureau. She said KIA looks at the specific census tracts being served by a particular project.

The third request was a Fund A Loan increase for the Ohio County Regional Wastewater District. The district is requesting a $14,226 increase to its $451,077 Fund A Loan for the Southern Elementary extension project. The new loan amount is $465,303 with a 20 year term and a two percent interest rate. The committee approved the original loan request at its December 2009 meeting.

Representative Rudy made a motion to approve the two Fund A loans and the Fund A loan increase. The motion was seconded by Senator Buford and passed unanimously by roll call vote.

KIA Fund B Loan – Nicholas County Sanitation District No. 2

The fourth loan request was a $550,000 Fund B loan for the Nicholas County Sanitation District #2 to construct a new collection and treatment system to serve 103 households at Lake Carnico. The loan term is 20 years with an interest rate of two percent.

Senator Leeper said he was concerned with the cost of the project given there is only 103 customers. He asked what rate of growth is expected in the area. Ms. Williams said the system will provide service to the current 103 customer and any additional development in the area. Joe Pavoni, Professional Engineer, GRW Engineers, said the system is designed to provide service for up to 165 homes, which is the maximum number of homes that can be developed in the area.

In response to a question from Representative Wayne, Mr. Pavoni said the county currently does not have planning and zoning laws. He said the original plan for this area was to send the wastewater to the City of Carlisle, however it is not economical.

In response to a question from Senator Buford, Mr. Pavoni said the Nicholas County Sanitation District is currently in the process of completing an agreement with the water district for billing services.

Senator Buford asked how KIA came up with the credit analysis for the project, considering it is a start-up utility and whether the sanitation district has established an office. Denny Gallagher, President and Chairman, Nicholas County Sanitation District #2, said that the district has not yet established an office. Ms. Williams said the information that was used for the credit analysis was based on the number of homes that are currently occupied and the water usage for each household.

In response to a question from Senator Leeper, Mr. Gallagher said the lake is a public lake, however the Nicholas County Development Corporation owns the property around the lake.

Senator Leeper asked if the project will still move forward if the 2012 General Assembly does not reallocate the $125,000 grant and if all the interested parties were aware that the grant money would be used for this project. Mr. Pavoni said both the County Judge Executive and the Mayor of Carlisle are in favor of using the $125,000 for the project. Mr. Gallagher said to his knowledge all parties involved are in support. Ms. Williams said the KIA Board approved the loan with the condition that the grant is reauthorized and reallocated by the General Assembly.

In response to a question from Senator Carroll, Mr. Pavoni said the residents currently pay about $120 every four to six weeks to have the septic tanks pumped.

Representative Rudy asked if private businesses in that area currently have their tanks pumped. Mr. Gallagher responded affirmatively and said the waste for businesses in the area is being hauled to Millersburg, Kentucky.

Senator Carroll made a motion to approve the Fund B loan. The motion was seconded by Senator Buford and passed unanimously by roll vote.

KIA Fund B loans

Ms. Williams said the fifth loan request was a $175,000 Fund B loan for the City of Beattyville in Lee County to replace deteriorating water lines. The loan term is 20 years with an interest rate of one percent. The loan is structured as 80 percent principal forgiveness.

In response to a question from Senator Carroll, Ms. Williams said the principal forgiveness is similar to that of a grant. KIA forgives 80 percent of the principal repayments for the borrower.

The sixth loan request was a $250,000 Fund B loan for the McLean County Fiscal Court for the benefit of the North McLean County Water District to construct a new water line and master meter. The loan term is 20 years with an interest rate of two percent.

Representative Rudy made a motion to approve the two Fund B loans. The motion was seconded by Representative Wayne and passed unanimously by roll call vote.

KIA Fund C Loan

The seventh loan request was a $621,000 Fund C loan for the Bracken County Water District to replace a 25-year-old water main from the pump house. The loan term is 20 years with an interest rate of three percent.

Representative Wayne made a motion to approve the Fund C loan. The motion was seconded by Senator Carpenter and passed unanimously by roll call vote.

KIA Fund F Loan

The eighth loan request was a $2,250,000 Fund F loan for the US 25 North Water Main Replacement Phase II and III project. The loan term is 20 years with an interest rate of two percent.

Representative Rudy made a motion to approve the Fund F loan. The motion was seconded by Senator Carpenter and passed unanimously by roll call vote.

KIA Grants

Ms. Williams indicated various coal and tobacco development grants authorized by the General Assembly were included in members' folders. No further committee action was needed.

School Bond Issues

Brett Antle, Deputy Director, OFM reported 10 new bond issues with SFCC debt service participation for Corbin Independent in Whitley County, Cumberland County, Fayette County, Glasgow Independent in Barren County, Grayson County, Nicholas County, Paris Independent in Bourbon County, Rockcastle County, Scott County, and Wayne County.

Representative Wayne made a motion to approve the 10 new bond issues with SFCC participation. The motion was seconded by Senator Carroll and passed unanimously by roll call vote.

Senator Leeper said there were two new local school district bond issues with 100 percent local debt service for Glasgow Independent in Barren County and Paducah Independent in McCracken County.

With there being no further business, Senator Carroll made a motion to adjourn the meeting. The motion was seconded by Representative Glenn and the meeting adjourned at 1:50 p.m.